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Drafting Considerations in Appointing the Surviving Spouse as Trustee of the Nonmarital Trust

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DRAFTING CONSIDERATIONS IN APPOINTING THE SURVIVING SPOUSE AS TRUSTEE OF THE NONMARITAL TRUST

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I. INTRODUCTION

Married persons frequently prefer to devise their entire estate to their surviving spouse. When advised of the federal estate taxes that might be imposed on the estate of the surviving spouse if the spouse inherited the entire estate, they are willing to consider alternative dispositions that would reduce the amount of the federal estate tax.

One of the first alternatives considered is a nonmarital trust. Use of a nonmarital trust—sometimes referred to as a "bypass" or "B" trust—allows the surviving spouse to receive the benefit of the inheritance, and yet have the inherited assets bypass the surviving spouse's estate for federal estate tax purposes.

For example, assume that a husband has a $1,200,000.00 adjusted gross estate and that his wife presently lacks an estate which would be subject to potential federal estate taxation. If the husband devises his entire estate to his wife, the unlimited marital deduction will ensure that there will be no federal estate tax upon his death. Upon his wife's subsequent death, however, the federal estate taxes will total $235,000.00. If, instead, the husband's will had provided that $600,000.00 of his estate would be transferred to a nonmarital trust, there would be no federal estate taxes on the death of either spouse.[1]

The projected federal estate savings from such a nonmarital trust soon leads clients to a critical question: who should be trustee? Spouses often have an immediate response: the surviving spouse should be named trustee of such a trust. This response is probably motivated by concern for the welfare of the surviving spouse (hereinafter referred to in the feminine for convenience only). Clients conclude that the widow should control the marital estate after her husband's death. Furthermore, she should probably decide what should be expended for the children's benefit.

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1. The federal estate tax computations are based upon the assumption that both husband and wife die after 1986 and that the unified credit is $192,800.00. No consideration of credits against the federal estate tax, other than the unified credit of I.R.C. § 2010 (CCH 1983), is made in these computations.

The lawyer counseling the couple, however, should indicate the advantages that favor the selection of a corporate trustee. Such advantages are set forth by a variety of commentators.[2] Despite these advantages, many clients will still prefer, if not insist, that the surviving spouse be named trustee of the nonmarital trust.

In naming the surviving spouse as trustee of the nonmarital trust, the lawyer could recommend a conservative approach in drafting the trust instrument. All of the income could be paid currently to the widow for her life. The remainder could pass outright to the children in equal amounts or to the descendants of any deceased child by representation. The trustee should not be given any power to accumulate or spray income. The trustee could not invade principal or in any fashion affect the beneficial enjoyment of the trust property. Consequently, ordinary income would be taxed currently to the wife as life beneficiary. Income allocable to principal, such as realized capital gains, would be taxed to the trust. Absent any compromising administrative provisions, the trust should achieve its major purpose, i.e., none of its principal would be included in the wife's gross estate.

Such a trust might serve some clients' estate planning goals. The testator would be assured that his surviving spouse would be able to manage, in a fiduciary capacity, the trust assets. Such a trust might also provide some assurances for the surviving spouse. She would not have to rely on some corporate entity, or anyone else, for the management of the trust property. Despite these assurances, both the testator and his wife would be struck with the inflexibility of such a trust. The trustee is prevented from making any distributions of principal to the wife based upon her needs which might exceed available trust income. Nor would the trustee be permitted to make distributions to the testator's children, or their issue, during the surviving spouse's lifetime. Additionally, such a trust prevents the surviving spouse from designating the proportions of trust principal to be distributed to the children after her death.

This article will focus on some additional dispositive powers which might be given the surviving spouse as trustee of a more flexible nonmarital trust. The estate, gift, and income tax consequences of each of these powers will be reviewed. Brief mention will be made of special considerations relative to a nonmarital trust, which is to be funded by way of disclaimer by the surviving

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2. Moore, *Choosing a Trustee—Individual or Corporate?*, 8 A.B.A. LAW NOTES 81 (1972); CCH FIN. & EST. PLAN, ¶ 1690; Bromberg & Fortson, *Selection of a Trustee; Tax and Other Considerations*, 19 SW. L.J. 523 (1965).

spouse. Finally, a summary of the administrative powers typically included in trust instruments will be discussed insofar as such powers might compromise the testator's objectives.[3]

II. Additional Dispositive Powers

A. *A power to distribute principal to the surviving spouse limited by an ascertainable standard relating to her health, education, support, or maintenance*

1. *Estate and Gift Tax*

One additional dispositive power which could make the nonmarital trust more flexible is a power in the trustee to make distributions of principal to the surviving spouse. This power must be limited by an ascertainable standard relating to her health, education, support, or maintenance. Without such a limitation, the spouse as trustee would have authority to make unrestricted distributions to herself as beneficiary. Such authority would constitute a general power of appointment within the definition of I.R.C. section 2041(b)(1). Consequently, the property subject to the power—i.e., the trust principal—would be included in the surviving spouse's gross estate.[4]

I.R.C. section 2041(b)(2) provides an exception to this general rule if the power is limited by an ascertainable standard relating to the power holder's "health, education, support, or maintenance." Additionally, such a power is not considered a general power of appointment for gift tax purposes.[5]

Sections 20.2041-1(c)(2) and 25.2514-1(c)(2) of the Treasury Regulations set forth some safe harbors for drafting ascertainable standards. Those safe harbors include distributions for "support," "maintenance," "education, including college and professional education," "health," and "medical, dental and hospital and nursing expenses and expenses of invalidism." The terms "support" and "maintenance" may be modified by the following phrases: "in his accustomed manner of living," "in health and reasonable comfort,"

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3. *See* Cox, *Income and Estate Tax Aspects of Surviving Spouse Beneficiary Serving as Executor-Trustee: Effect of Stranger as Co-Trustee*, 22 N.Y.U. Inst. 1041 (1964) and Crane, *The Surviving Spouse as Sole Trustee—A Neglected Estate Planning Tool*, 9 Ohio N.U.L. Rev. 205 (1982) for a discussion of tax issues associated with service by the surviving spouse as trustee of the nonmarital trust.

4. I.R.C. § 2041(a)(2) (CCH 1983).

5. I.R.C. § 2514(c)(1) (CCH 1983).

and "in reasonable comfort." These regulations indicate that the terms "support" and "maintenance" are synonymous and that the two terms include more than the bare necessities of life.

In addition to providing safe harbors for drafting purposes, sections 20.2041-1(c)(2) and 25.2514-1(c)(2) of the Treasury Regulations include language which does not create an ascertainable standard. A trust instrument which allows the trustee to make distributions to herself for her "welfare," her "happiness"[6] or her "comfort" is not limited by ascertainable standards.

The reporters are replete with examples of attempts by draftsmen to deviate from the safe harbors of the Regulations. Some of these attempts have achieved unbelievable success, after litigation.[7] For example, in *Barritt v. Tomlinson*,[8] the trust instrument gave the life beneficiary authority to use principal "as she may see fit." The court held that such was an ascertainable standard under local law within the meaning of section 2041(b)(2). Similarly, a court held that the authority to withdraw principal "as he may from time to time request, he to be the sole judge of his needs" was also limited by the appropriate ascertainable standard.[9]

In contrast, another court has held that authority to receive "such amount out of the principal, as my said wife may from time to time require" was not limited by an ascertainable standard.[10] A power to invade if "necessary or advisable in order to provide for . . . reasonable needs and proper expenses or . . . benefit or comfort" was also held not limited by an ascertainable standard.[11] Similarly, a power to invade principal in the event of need for "care, comfort and enjoyment" was held not to be an ascertainable standard.[12] Differences in local law can explain some of these ap-

6. One court has held that "happiness" constitutes an ascertainable standard. *See* Brantingham v. United States, 631 F.2d 542 (7th Cir. 1980). However, the Service will not follow that decision. Rev. Rul. 82-63, 1982-1 C.B. 135.

7. *See generally*, Alessandroni, *Tax and Other Implications of Powers Measured by a Definite or Ascertainable Standard*, 4 INST. ON ESTATE PLAN. ¶ 70.900 (1970) [hereinafter cited as Alessandroni].

8. 129 F. Supp. 642 (S.D. Fla. 1955).

9. Pittsfield Nat'l Bank v. United States, 181 F. Supp. 851 (D. Mass. 1960).

10. Peoples Trust Co. v. United States, 412 F.2d 1156 (3d Cir. 1969).

11. Strite v. McGinnes, 330 F.2d 234 (3d Cir. 1964), *cert. denied*, 379 U.S. 386 (1964), *reh'g denied*, 379 U.S. 910 (1964).

12. Stafford v. United States, 236 F. Supp. 132 (E.D. Wis. 1964). A number of other cases indicate that the term "comfort" used by itself may not constitute an ascertainable standard within the meaning of I.R.C. § 2041(b)(1)(A) (CCH 1983). *See* First Virginia Bank v. United States, 490 F.2d 532 (4th Cir. 1974), where an invasion power for "comfort and care" was found not limited by an ascertainable standard. Similarly, in Whelan v. United States, 81-1 U.S. Tax Cas. (CCH) ¶ 13,393 (S.D. Cal. 1980), where an invasion power for "reasonable support, care, and comfort" was deemed not ascertainable. On the other hand,

parently inconsistent conclusions.

The Internal Revenue Service (Service) takes the position that a power given to the trustee-beneficiary to make a distribution to "meet an emergency" is not within the protection of Section 2041(b)(1)(A) and 2514(c)(1). The basis for the Service's position is that the term "emergency" relates to the timeliness of a distribution and does not necessarily relate to health, education, support, or maintenance.[13] While the Tax Court has upheld the Service, the Tenth Circuit Court of Appeals has held that the Trustee's authority to distribute principal to herself "to meet an emergency" is limited by an ascertainable standard under New Mexico law.[14]

Reliance on case law favorable to taxpayers, however, simply does not make sense from a planning perspective. A draftsman who deviates from the safe harbors of the Regulations should expect a challenge by the Service.[15]

Even if the draftsman has cautiously used safe harbor language from the regulations, he should forego the temptations to increase trust flexibility to limit trustee liability by adding phrases such as "in the trustee's uncontrolled and absolute discretion," "without regard to local law," or "without liability except for fraud." Typically, where a standard for distribution is stated in a trust instrument, the courts will not interfere with the trustee's discretion unless the power is abused.[16] So long as the trustee's discretion is not modified by some of the above phrases, the courts will preempt the trustee's powers only if they are unreasonably exercised.

In addition, if the discretion is "uncontrolled," "unfettered," or "absolute," the courts will have power to review the exercise (or nonexercise) of the power. The scope of the courts' review in such circumstances is unclear. The Restatement of Trusts indicates that the use of such terms as "absolute," "unlimited," or "uncontrolled" merely dispenses with the standard of reasonableness.[17] The trustee must act "in a state of mind in which it was contemplated by the settlor that he would act . . . . Thus, the trustee will

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the standard "reasonable care, comfort and support" has been deemed ascertainable. Tucker v. United States, 74-2 U.S. Tax Cas. (CCH) ¶ 13,026 (S.D. Cal. 1974). The court did not discuss whether "comfort" was being regarded as a separate and independent standard.

13. *See* Private Letter Rul. 7841006; Private Letter Rul. 8304009.

14. Sowell v. Comm'r, 74 T.C. 1001 (1980), *rev'd*, 708 F.2d 1564 (10th Cir. 1983).

15. *See* Rev. Rul. 77-60, 1977-1 C.B. 283; Private Letter Rul. 8121010; Private Letter Rul. 8228001; Private Letter Rul. 8249015.

16. *See* A. Scott, The Law of Trusts § 187 (3d ed. 1967); G. Bogert, Trusts & Trustees § 56 (rev. 2d ed. 1980).

17. Restatement (Second) of Trusts § 187 comment j (1959).

not be permitted to act dishonestly, or from some motive other than the accomplishment of the purposes of the trust, or ordinarily to act arbitrarily, without an exercise of judgment."[18] Despite this position of the Restatement, some case law suggests that when, for example, a payment to a beneficiary is unreasonably small, the trustee has failed to act "in a state of mind contemplated by the settlor."[19]

In short, the effect of such terms as "uncontrolled," "unfettered," or "absolute" discretion is unclear. Certainly, they are likely to expand the definition of reasonableness. A California court has held that the words "uncontrolled discretion" destroyed an otherwise ascertainable standard.[20] Consequently, if an ascertainable standard is to be used, prudence directs that the draftsman stay within the unmodified safe harbors of the Regulations.

Even when the trustee has discretion to make distributions of principal to herself limited by a properly drafted ascertainable standard, a question could arise if the trustee elects not to make a distribution when the standard has been triggered. Section 20.2041-1(c)(2) of the Treasury Regulations suggests that it is necessary to exercise the discretion if the standard is met.[21] Consequently, from a drafting standpoint, the trustee should be directed to make a distribution in mandatory language (e.g., "shall") and not be given discretion in permissive language (e.g., "may").[22]

2. *Income Tax*

The existence of a power in the trustee to distribute trust principal to herself raises a possibility that trust capital gains may be income taxable to the trustee-beneficiary. Section 678(a)(1) of the I.R.C. treats the beneficiary as the owner of any portion of a trust over which such a person has a power exercisable solely by herself to vest the principal or income in herself. If a person is

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18. *Id.*

19. *See* Colin v. Murdock, 137 N.J. Eq. 12, 43 A.2d 218 (1945).

20. Friedman v. Cory, 94 Cal. App. 3d 667, 156 Cal. Rptr. 597 (1979).

21. Additionally, if I.R.C. § 2514(e) would treat a failure to make a distribution as a lapse, it is arguable that a portion of the trust capital gains could be subject to income tax under I.R.C. §§ 674, 677.

22. See Form A of the Appendix for an example of trust language requiring a distribution if the ascertainable standard is met. The form is modeled after that suggested by J. Horn, *Planning Flexible Trusts for Nonprofessional Trustees: Analysis of Choices for Draftsmen*, 4 Est. Plan. 172, 177 (1977). This form also requires the consideration of the appointee's other resources. This will probably coincide with the testator's intent. Additionally, it represents a conservative approach to ensure that an ascertainable standard has been stated. Finally, note the absence of language which might broaden the standard, such as "in the trustee's absolute discretion."

treated as the owner of a trust under section 678(a)(1), section 671 provides for taxing the income of that portion to the beneficiary. Section 678 does not contain an express statutory exception for distributions limited by ascertainable standards, as do sections 2041 and 2514.

It is arguable that if the standard for distribution meets one of the exceptions to section 674, it should not cause section 678 tax treatment to a trustee-beneficiary. Generally, section 674(a) causes a grantor of a trust to be taxed on trust income if he, or a nonadverse party,[23] has the ability to control the beneficial enjoyment of trust property without the consent of an adverse party.[24] One exception to the general rule of section 674(a) is an authority to distribute principal to a beneficiary or beneficiaries or to or for a class of beneficiaries provided the power is limited by a "reasonably definite standard" which is set forth in the trust instrument.[25]

A second and similar exception to the general rule of section 674(a) relates to the distribution of income. A trustee (other than the grantor or the grantor's spouse living with the grantor) may distribute, apportion, or accumulate income for beneficiaries if such power is limited by a "reasonably definite external standard" which is set forth in the trust instrument.[26] The Regulations suggest that the standard relating to the principal of the trust in section 674(b)(5)(A) is the same as the standard relating to the income of the trust in section 674(d).[27] In other words, the term "external" adds nothing to the standard of sections 674(b)(5)(A) and (d).[28]

There is a distinction, however, between the standard of these subsections and the ascertainable standard of sections 2041 and 2514. For example, authority in the trustee to make distributions to herself for "her reasonable support and comfort" or "to meet an emergency" are within the safe harbors of the regulations under section 674 but are not within the safe harbors of the regulations under sections 2041 and 2514. Clearly, for example, the authority to distribute principal for "health, education, and support" would be within the safe harbors of the regulations under all of these sec-

23. I.R.C. § 672(b) (CCH 1983) defines a non-adverse party as any person who is not an adverse party.

24. I.R.C. § 672(a) (CCH 1983) defines an adverse party as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

25. I.R.C. § 674(b)(5)(A) (CCH 1983).

26. I.R.C. § 674(d) (CCH 1983).

27. *See* TREAS. REG. §§ 1.674(b)-1(b)(5)(i), 1.674(d)-1.

28. *See* Alessandroni, *supra* note 7, at ¶ 70.907.

tions. It is arguable, then, that a standard which meets the requirements of section 674 should not cause income taxation under section 678.

Unfortunately, relevant case law is scarce. An often-cited case in favor of the taxpayer on this issue is *United States v. DeBonchamps*.[29] The beneficiaries of life estates had powers to invade principal for "needs, maintenance, and comfort." The Service contended that those powers should cause the holders to be taxed on capital gains. The court rejected the Service's contention and concluded that the limits on the power did not cause taxation under section 678.[30] A series of cases under the pre-1954 Code also reached the same conclusion, so long as the power is limited.[31] If the power to invade principal is unrestricted, however, income will be taxed to the holder.[32]

It is unclear whether the Service intends to pursue this issue. The Service did hold in Private Letter Ruling 8211057 that a trustee who had authority to invade trust principal for her "support, welfare, and maintenance" would be treated as the owner of the trust under section 678. The Service emphasized that a sole individual beneficiary held the power. The Service did not discuss whether the invasion power constituted an ascertainable standard.[33]

This uncertainty has caused a number of commentators to state that the lack of an express statutory exception to section 678 and the lack of sufficient precedents to support such an exception does not give the kind of confidence estate planners would generally appreciate.[34] The risk in the prototype trust suggested in this

29. 278 F.2d 127 (9th Cir. 1960). *See also* Security-First Nat'l Bank v. United States, 181 F. Supp. 911 (S.D. Cal. 1960).

30. The Ninth Circuit's decision has support in the legislative history of I.R.C. § 678: "A person other than the grantor may be treated as the substantial owner of a trust if he has an *unrestricted* power to take the trust principal or income . . . ." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A211, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4145, 4357. (emphasis added).

31. *See* Townsend v. Comm'r, 5 T.C. 1380 (1945); May v. Comm'r, 8 T.C. 860 (1947); Oppenheimer v. Comm'r, 16 T.C. 515 (1951); United States v. Smither, 205 F.2d 518 (5th Cir. 1953); United States v. Funk, 185 F.2d 127 (3d Cir. 1950); Spies v. United States, 84 F. Supp. 769 (N.D. Iowa), *aff'd*, 152 F.2d 562 (2d Cir. 1945); Koffman v. United States, 300 F.2d 176 (6th Cir. 1960).

32. *See* Falk v. Comm'r, 189 F.2d 806 (3d Cir. 1951); Hirshmann v. United States, 202 F. Supp. 722 (S.D.N.Y. 1962).

33. Clearly, the term "welfare" would not constitute an ascertainable standard under I.R.C. § 2041(b)(2) or I.R.C. § 2514(c)(1) (CCH 1983).

34. *See* Halbach, *Power of Distribution, Invasion and Appointment*, 32 MAJOR TAX PLAN. ¶ 1404.2 (1980) [hereinafter cited as Halbach]; Strauss, *Selection of a Trustee: Beneficiary-Trustees*, 28 N.Y.U. INST. 853, 867 (1970) [hereinafter cited as Strauss].

article is limited to the trust's capital gains, since the surviving spouse is the beneficiary of the ordinary income. Whether this additional risk is of sufficient magnitude to deter clients from adding such a power is a decision to be made on a client-by-client basis.

B. *An intervivos power to distribute principal to the testator's children and their descendants subject to certain limitations*

A second additional dispositive power which could make the nonmarital trust more flexible is a power in the trustee to make distributions of principal to the testator's children (and perhaps other descendants). Logic would suggest that if the trustee is permitted to make principal distributions to herself limited by an ascertainable standard and avoid estate tax exposure, she should be able to have a similar power to make distributions to her children and their descendants without any estate tax exposure. Reliance on such logic, however, is misfounded if the trustee has an obligation to support the child or descendants.

1. *Estate Tax*

Treasury Regulation sections 20.2041-1(c)(1) and 25.2514-1(c)(1) provide that a power exercisable for the purpose of discharging the legal obligation of the donee or for his pecuniary benefit is a general power of appointment. As a result, the property subject to a general power of appointment will be included in the power holder's estate under section 2041, and an exercise of the power would be subject to gift tax under section 2514. In a 1979 Revenue Ruling,[35] the Service indicated that the principal of a trust would be included in the gross estate of a person who had a power to appoint the trust property for the health, education, support, and maintenance of the power holder's children, if the power holder had a legal obligation to support the children. The ascertainable standard exception of section 2041(b)(1)(A) and section 2514(c) applies to distributions made *directly to the power holder.* No such exceptions exist if the distribution is to another person.

Certainly, one could argue with the Service's position. It is unreasonable that a person would be deemed to have a general power of appointment if she can use trust property for the benefit of another person and yet not be deemed to have a general power if she can use trust property for her own benefit if limited by an ascertainable standard. The term "legal obligation" used in the regula-

35. Rev. Rul. 79-154, 1979-1 C.B. 301.

tion should be construed to apply to the claims of creditors and similar obligations, rather than the legal obligation of support. Furthermore, state law typically provides that trust distributions are to satisfy a person's legal obligation to support in only two circumstances: one, when the trust was established for the express purpose of discharging that support obligation; and two, when the person obligated to provide support is financially unable to do so.[36]

From the standpoint of planning, the simple solution is merely to restrict distributions so that none will satisfy the trustee's obligation of support.[37] Such a restriction has been given effect by the courts.[38]

2. *Gift Tax*

As previously noted, the trust prototype suggested in this article provides that the surviving spouse is to receive all income of the trust during her lifetime. If she, as trustee, is also given an intervivos authority to appoint trust principal to the testator's children and their descendants, would not such an appointment constitute a gift, within the meaning of section 2511(a)? That section effectively imposes federal gift taxation on transfers of property in which the transferor has a beneficial interest. If the spouse-trustee makes an intervivos appointment of principal, she has in fact transferred the trust income that would be generated from the appointed principal. Treasury Regulation section 25.2514-1(b)(2) suggests such a result.

However, Treasury Regulation section 25.2511-1(g)(2) provides in pertinent part:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or non-exercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument.[39]

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36. *See generally*, 59 AM. JUR. 2D *Parent and Child* § 77 (1971).

37. See Form B of the Appendix for an example of trust language which prohibits distributions which would satisfy the trustee's obligation to support. Such a limitation may benefit trusts other than those which are the subject of this article, in an attempt to limit generation skipping transfer tax liability. Proposed Treas. Reg. § 26.2613-4(c)(3) indicates that anyone whose legal obligation of support may be discharged by trust distributions is a beneficiary of a trust by virtue of this potential discharge. The proposed regulations take this position regardless of who serves as trustee.

38. *See* Upjohn v. United States, 72-2 U.S. Tax Cas. (CCH) ¶ 12,888 (W.D. Mich. 1972); William v. United States, 378 F.2d 693 (Ct. Cl. 1967); *Cf.* Rev. Rul. 81-6, 1981-1 C.B. 385.

39. See Form B of the Appendix for an example of trust language which limits distributions to the ascertainable standard of health, education, and support.

Consequently, so long as the power to distribute to the children (or their descendants) is held in a fiduciary capacity, and so long as the trust instrument limits such intervivos distributions to an ascertainable standard, an exercise by the trustee of the power should not generate any gift tax.[40]

3. *Generation Skipping Transfer Tax.*

The addition of authority in the trustee-spouse to make distributions to the testator's children and their descendants causes some potential generation skipping transfer tax exposure.[41] For the purposes of that tax, a beneficiary is defined as any person who has a present or future interest or power in trust.[42] Section 2613(d)(1) indicates that a person has an interest in the trust if he has a right to receive income or corpus from the trust or is a permissible recipient of such income or corpus. The testator's surviving spouse has an interest in the trust by reason of her right to trust income. Additionally, a child of the testator will have a present interest in the trust by reason of the trustee's ability to distribute principal to the child based upon an ascertainable standard. If a child survives the testator, but predeceases the surviving spouse, there would be a potential generation skipping tax because his death would produce a "taxable termination" within the meaning of section 2613(b)(1). The generation skipping tax would be deferred until the surviving spouse's death.

This generation skipping transfer tax exposure may cause the testator to conclude that no authority should be given to make distributions to his children during the term of the trust.[43] The surviving spouse might meet the needs of the children or their descendants from her own funds.

On the other hand, the testator might conclude that the additional flexibility in the trust by including authority for the trustee

40. In Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), the income beneficiary of a trust had a non-fiduciary power to appoint trust principal to his descendants. The power was not limited by an ascertainable standard. The Court of Claims concluded that the exercise of such a power was not subject to gift taxation and reasoned that the donee was acting as the agent of the donor.

The court's ruling appears contrary to Treas. Reg. § 25.2514-3(e) Example (1). The Service has indicated that it does not intend to follow *Self* to the extent that it is contrary to the regulations. Rev. Rul. 79-327, 1979-2 C.B. 342.

41. *See generally*, Halbach, *supra* note 34, at ¶ 1403.3.

42. I.R.C. § 2613(c)(3) (CCH 1983).

43. The children's only interest would be a future one as remaindermen upon the termination of the trust, and a taxable termination by definition, does not include a termination of an interest of any person who only has a future interest in the trust. I.R.C. § 2613(b)(1) (CCH 1983).

to make distributions to the children (and their descendants) outweighs the disadvantages of generation skipping transfer tax exposure. The likelihood of imposition of the generation skipping transfer tax may be minimal. First, a taxable termination will only occur in an unlikely order of deaths. A child must predecease the surviving spouse, but not the testator. Second, the "grandchild exclusion" excludes from the generation skipping transfer tax transfers to grandchildren up to the amount of $250,000.00 per child of the testator.[44]

C. *A power in the surviving spouse to withdraw annually the greater of $5,000.00 or five (5) percent of the trust principal*

A third additional dispositive power which could make the nonmarital trust more flexible is a power in the surviving spouse to withdraw annually the greater of $5,000.00 or five (5) percent of the trust principal. The prototype for the nonmarital trust only provides for trust income to be distributed to the surviving spouse. Even if the testator elects to include a power in the trustee-spouse to make distributions of principal to herself as beneficiary, such distributions must be limited to an ascertainable standard relating to health, education, support, and maintenance.[45] The testator could envision, for example, a situation where his spouse would like to travel and trust income would not be sufficient to discharge the projected travel expenses. Further, the proposed travel might not be justified under an ascertainable standard within the meaning of sections 2041(b)(1)(A) or 2514(c)(1). The right of the surviving spouse to additionally withdraw the greater of $5,000.00 or five (5) percent of the trust principal could provide her with at least some of the money she might want to implement her travel plans.

The so-called "five or five" power has even more practical uses when the surviving spouse is not named trustee of the nonmarital trust. If the testator names a corporate trustee, for example, the unfettered right in the spouse to withdraw the greater of $5,000.00 or five (5) percent of the trust principal can be reassuring to the testator and also tend to reduce potential conflict between the surviving spouse and the trustee. Thus, the use of the five or five power is not unique to the situation when the surviving spouse is to be trustee. However, because of the unusual estate, gift, and income tax features of such a power, a discussion of the power is advisable.

44. I.R.C. § 2613(b)(6) (CCH 1983).

45. *See supra* text accompanying notes 4-22.

1. *Estate and Gift Tax*

By definition, a general power of appointment is one which is exercisable in favor of the donee, the donee's estate, the donee's creditors, or the creditors of her estate.[46] The donee's dominion over the appointive property is tantamount to ownership. The donee's dominion terminates after an effective exercise of the power in favor of an appointee. Additionally, the dominion terminates after a release of the power to takers in default. The donee's dominion also terminates after a lapse of the power. A release or a lapse is just as functional as an exercise in terminating the donee's dominion over the appointive property. Both a release and a lapse affect the beneficial enjoyment of the property. For the purposes of the federal estate and gift tax, a release or a lapse constitutes a conveyance of the appointive property by the donee.[47]

The gross estate includes property which is subject to a general power of appointment which lapses upon the decedent's death. The gross estate also includes property with respect to which the decedent at any time exercised or released a general power of appointment which is of such a nature that, if it were a transfer of property owned by the decedent, the property would be includable in the decedent's gross estate under sections 2035 to 2038.[48] The lapse of a general power is treated as a "release" of such a power.[49]

For example, assume that the donee of a general power of appointment is also the income beneficiary of a trust. The general power is limited to the right to withdraw a specified dollar amount from the trust on a certain date. If the donee allows her power to lapse, she would have made a transfer of the specified dollar amount and would have retained the right to income therefrom for life. If this had been a gratuitous transfer by the donee of owned property with the retention of income for her life, it would be includable in her gross estate under section 2036(a)(1). Consequently, it is included in her estate under section 2041(a)(2).

The first sentence of section 2041(b)(2) provides that the lapse of a general power is to be considered a release. Additionally, that subsection further reads:

> The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the prop-

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46. I.R.C. §§ 2041(b), 2514(c) (CCH 1983).
47. I.R.C. § 2041(a)(2) (CCH 1983) includes a release in the gross estate. Section 2041(b)(2) includes a lapse in the gross estate. I.R.C. § 2514(b) (CCH 1983) prescribes similar gift tax consequences for a release and § 2514(e) does the same for a lapse.
48. I.R.C. § 2041(a)(2) (CCH 1983).
49. I.R.C. § 2041(b)(2) (CCH 1983).

erty, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

A. $5,000.00, or

B. Five (5) percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

The preceding language provides the basis for the five or five power. As noted above, if the life beneficiary of a trust had a right to withdraw $5,000.00 each calendar year, and if she elects not to exercise her power in a given year, she will not be deemed to have made a transfer for federal estate tax purposes. Absent the previously quoted language of section 2041(b)(2), the life beneficiary would have to include the property subject to the power in her gross estate. A similar exception is applicable for gift tax purposes in section 2514(e).

Drafting the five or five power should be done carefully, considering sections 2041(b)(2) and 2514(e). The power should be limited to withdrawals in each calendar year. It should expressly be made noncumulative. It should provide that any amount not withdrawn in any calendar year shall lapse and may not be withdrawn in any other year. Finally, it should specify when the power shall lapse.[50]

The existence of the five or five power is not without its potential estate tax cost. If the donee dies not having exercised the power in the year of her death, the greater of $5,000.00 or five (5) percent of the value of the trust principal would be included in her estate under section 2041. Many clients will conclude that such is a small cost to pay for the added flexibility given the spouse for the years she survives the husband.

It has been suggested that if the withdrawal power is limited to a brief period, such as the last month of any year, and if the donee dies during any of the other eleven months of the year, the amount subject to withdrawal would not be includable in her estate because the donee would not have a power of appointment on the date of her death.[51] The author is unaware of any case law

50. Such a five or five power could be modeled after that suggested by Farrell, *Power to Invade a Trust Need Not Result in Tax to a Beneficiary*, 8 TAX'N FOR LAW 32 (1979). See Form C of the Appendix for an example of a five or five power.

51. A. CASNER, ESTATE PLANNING, 1243 n.57 aa (3d ed. Supp. 1978); Strauss, *supra* note 34, at 879; Halbach, *supra* note 34, at ¶ 1402.2j Moore, *Caution: Boilerplate May Be Hazardous to Your Client's Tax Health*, 14 INST. ON EST. PLAN. ¶ 501.7 (1980); Turley, *The Five or Five Power: An Obscure Estate Planning Tool*, 33 WASH. & LEE L. REV. 701, 706 (1976).

relating to this device. In any event, even if the device is unsuccessful, the estate tax cost is minimal.

2. *Income Tax*

The existence of the five or five power should have no impact on the ordinary income of the trust because our prototype already provides that the surviving spouse will receive the net income of the trust. However, the power will cause the surviving spouse to be taxed upon a portion of the capital gains of the trust.[52] As noted, section 678(a) provides that a person other than the grantor shall, for income tax purposes, be treated as the owner of any portion of a trust with respect to which such person has a power, exercisable solely by herself, to vest the principal or income therefrom, in herself.[53] For example, if the trust principal equals or exceeds $100,000.00, the right of withdrawal is limited to five percent of the value of the trust assets. The donee will be subject to income taxation on five percent of the trust's capital gains. If the trust principal is less than $100,000.00, then the donee will be subject to income taxation on a percentage of the trust determined by dividing $5,000 by the value of the trust assets on the last day of the existence of the power. For example, assume that the value of the trust principal totals $62,500.00 on the last day of the year. The donee will be subject to income taxation on eight (8) percent of the capital gains of the trust. ($5,000/$62,500 = 8%). Again, this income tax cost is small compared with the greater trust flexibility.

A series of five or five power lapses presents a potentially more serious problem in regard to capital gains. The Service could argue that the donee should be taxed on an ever increasing percentage of the trust capital gains under sections 671 through 677. Thus, the donee could be treated as the owner of the five percent of the trust after the first calendar year in which her power lapsed, as owner of ten (10) percent after the second calendar year, and so on.[54]

Certainly, there are ample arguments that lapses of the five or five power should not cause such a result. Neither sections 671 through 679, nor any of the regulations thereunder, define "grantor." Common law should suggest that the husband in our prototype trust should be deemed the "grantor" because he created the trust by way of his will. Furthermore, under the relation back doctrine, the husband is treated as the donor and the wife is treated

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52. Rev. Rul. 67-241, 1967-2 C.B. 225.
53. *See supra* text accompanying notes 23-34.
54. A. CASNER, ESTATE PLANNING, 1279, n.78 (4th ed. 1980).

as the donee. The appointee is deemed to have received the property from the donor, not the donee. While admittedly sections 2041 and 2514 constitute an express nonacceptance of the relation back doctrine for estate and gift tax purposes, there is no corresponding section of the code for income tax purposes. If these sections are to be relied upon to determine who is the grantor of the trust for income tax purposes, then they should be looked to in their entirety and apply only to lapses which surpass the five or five protection of section 2041(b)(2) and 2514(e).[55]

The absence of case law on this question suggests that the question may be more academic than real. Even if the Service should successfully advance this contention, the exercise of the five or five power should provide the donee with ample resources to satisfy any increased income tax liability as the result of the trust's capital gains. Furthermore, again, many will conclude that this potential income tax cost should not deter the use of the five or five power in light of the increased trust flexibility.

D. *A special testamentary power of appointment in the surviving spouse to appoint the principal among the testator's descendants*

A fourth additional dispositive power which could increase the flexibility of the nonmarital trust is a testamentary power, in the surviving spouse, to appoint the trust principal among the testator's descendants.[56] Such a power allows the surviving spouse a second look at the needs and circumstances of the testator's descendants at a time closer to the ultimate distribution of the remainder. The mere existence of such a power may also promote, superficially at least, a more satisfactory relationship between the surviving spouse and the testator's descendants. Because the permissible appointees are limited to the testator's descendants, the trust principal will not, by definition, be subject to the estate tax under section 2041. Furthermore, the existence of the power does not raise any income tax issues.

III. Nonmarital Trusts Funded By Way of Disclaimer by the Surviving Spouse

With the enactment of section 2518 as part of the Tax Reform

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55. *See* Huff, *The "Five or Five" Power and Lapsed Powers of Withdrawal*, 15 Inst. on Est. Plan. ¶ 700 (1981) for a thorough analysis of these income tax issues.

56. See Form D of the Appendix for an example of such a special testamentary power of appointment.

Act of 1976[57] and its modification by the Revenue Act of 1978[58] and the Economic Recovery Tax Act of 1981,[59] a number of lawyers have recommended that their clients with moderate sized marital estates (approximately $400,000 to $750,000) consider the use of "standby" nonmarital trusts. Typically, the surviving spouse is given the entire residuary estate in a fashion that qualifies for the marital deduction. Additionally, the will includes provisions for a nonmarital trust to be funded, if at all, by way of a qualified disclaimer.[60] The use of this standby nonmarital trust attracts some clients for a number of reasons. Because of their age, their health, the current value of their marital estates, their inability to accurately forecast any increases or decreases in such values, and the scheduled phase-in of the unified credit under section 2010, these clients are uncertain whether they wish to require the establishment of a nonmarital trust in their wills. The use of the standby trust offers clients a means of postponing their decision. The surviving spouse may decide on the need for such a trust within the period of section 2518(b)(2) and applicable state law after the death of the first spouse to die. By then, a number of the client's questions should be resolved. While the use of this device apparently increases flexibility for the surviving spouse, at least, it also has its drawbacks.[61]

The four requirements of a qualified disclaimer are set forth in section 2518(b). First, the refusal must be in writing. Second, the writing must be received no later than nine months from the death of transferor (or the date on which the disclaimant attains age twenty-one). Third, the disclaimant must not have accepted the interest or any of its benefits. Fourth, the interest must pass, without any direction on the disclaimant's part, either to the decedent's spouse, or to some person other than the disclaimant.

This fourth requirement—that the interest pass without any direction on the part of the disclaimant—raises a question over the permissible powers which might be granted the spouse as trustee of the standby trust. The test set forth in the proposed regulations is whether "the surviving spouse [can] direct the beneficial enjoyment of the disclaimed property [to another person] in a transfer

57. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009, 90 Stat. 1520, 1893 (1976).

58. Revenue Act of 1978, Pub. L. No. 95-600, § 702, 92 Stat. 2763, 2935 (1978).

59. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 425, 95 Stat. 172, 318 (1981).

60. See Form E of the Appendix for an example of a disposition to nonmarital trust which may be funded by way of disclaimer.

61. *See* Carpenter & Hanna, *Disclaimers: A Pre-Mortem Estate Planning Tool*, 121 TRUSTS & ESTATES 47 (1982).

that is not subject to Federal estate and gift tax."[62] The Proposed Regulations indicate, by way of example, that the surviving spouse cannot have a special power to appoint principal among designated beneficiaries.[63] Consequently, it would appear that the spouse trustee could not be given a special intervivos power to distribute principal to the testator's children or their descendants. Additionally, she should not be given a special testamentary power of appointment to appoint the principal among the testator's descendants.

Example 6 of the same Proposed Regulation permits a qualified disclaimer to a trust where the spouse has an income interest and a power to invade principal for her health and maintenance. The reasoning is unclear, but apparently, the surviving spouse's interest as a potential appointee of the principal of the nonmarital trust does not disqualify the disclaimer because any portion of the nonmarital trust passing to another pursuant to the surviving spouse's subsequent direction will be subject to transfer tax.[64] This author is uncertain of the soundness of this example of the proposed regulation. The surviving spouse's power to invade for her health or maintenance gives the surviving spouse the power to direct the disposition of the property. Perhaps it can be rationalized on the theory that if she does not exercise the power, the spouse in effect permits the property to pass to the remaindermen of the trust free of additional transfer tax. The remaindermen already have received the property subject to a transfer tax on the death of the first spouse to die. Put another way, without the invasion power, the remaindermen would receive the property anyway. The addition of the invasion power only allows the surviving spouse to invade for her own benefit.[65] Any subsequent transfer by her would be subject to transfer tax.

If the preceding is an accurate rationalization of the Service's position, then it would follow that the surviving spouse could also be given a five or five power. If she exercises her power and subsequently makes a transfer, the latter transfer would be subject to transfer taxation. If she fails to exercise her five or five power, the property subject to the power in the year of her death would be included in her gross estate. The remaindermen would receive the property anyway.[66]

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62. Proposed Treas. Reg. § 25.2518-2(e)(2).

63. Proposed Treas. Reg. § 25.2518-2(e)(5) Example (5).

64. Proposed Treas. Reg. § 25.2518-2(e)(5) discussed in Frimmer, *Proposed Regs under Section 2518 Explain and Expand the Federal Disclaimer Statute*, 53 J. TAX'N 266, 269 (1980).

65. *Id.*

66. Not all commentators agree with this analysis. *See* Mulligan, *Proposed Regula-*

The uncertainty in this area suggests that the surviving spouse should not be given any of the four proposed discretionary powers discussed in the preceding section. In other words, if the spouse is to serve as trustee of a standby trust, the trust should simply include the provisions of the prototype. She should receive all of the current income for life. Upon her death, the remainder could pass outright to the children in equal amounts or the descendants of any deceased child by representation.

If more flexibility is desired for the standby trust, the spouse simply should not be appointed trustee or a standby trust should not be used. Perhaps this lack of flexibility in the dispositive provisions of the trust may be counterbalanced by the greater flexibility given to the surviving spouse to determine the extent the trust is to be funded. She might decide to disclaim less so that she will receive a greater portion of the residuary estate outright. Obviously, her discretion over the subsequent disposition of the nondisclaimed property in such a situation would be essentially unlimited.

IV. Administrative Powers

Administrative powers do not directly address the time when the trust beneficiaries will receive the benefits of trust income or principal, the extent of such benefits, or the identity of the beneficiaries. These considerations, which are usually referred to as dispositive powers, are typically drafted with the careful consideration of their estate, gift, income, and generation skipping transfer tax effects.

Conversely, administrative provisions deal with the details of trust operation. Typically, administrative provisions are added to the trust instrument to expand the trustee's powers. Such powers might include special powers for the management of real property, additional authority to allocate receipts and expenses between principal and income, express authority to retain assets, and so on.

State Street Trust Co. v. United States[67] is often cited as an illustration of the unintended and unfavorable tax results that can flow from trust administrative powers. In that case, the trustees were given power to exchange trust property for other property without reference to the value of the properties, the power to invest assets in securities yielding either higher rates of income or no

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tions Do Not Solve Ambiguities in Planning for Effective Use of Disclaimers, 10 EST. PLAN. 8, 10 (1983).

67. 263 F.2d 635 (1st Cir. 1959).

income at all, and the discretion to allocate assets to principal or income. Additionally, the trust instrument provided that the trustees were liable only for willful acts or defaults, but not for errors in judgment, however gross. The settlor of the trust was one of the trustees. The court noted that these powers, considered as a whole, would allow the trustees to substantially shift the economic benefits of the trusts between life tenants and remaindermen. Consequently, the court held that the trust principal was includable in the trustee's gross estate under the predecessor of section 2036.[68]

Where the surviving spouse is to be the trustee of a nonmarital trust, the chief tax concern lies with section 2041. If she is the income beneficiary and has an administrative power to invest in assets which will yield extraordinary income for the benefit of herself at the expense of the remaindermen, does she not, in effect, have a power to appoint property to herself? Additionally, could it also be argued that she has power to vest corpus in herself within the meaning of section 678(a)? If the surviving spouse is the income beneficiary and has the power to invest in assets which will yield little, if any, income for the ultimate benefit of an increasing trust principal, could not such an investment constitute a taxable gift?[69]

Fortunately, the Regulations offer the taxpayer some assurances. Treasury Regulation section 20.2041-1(b) provides in part:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interest therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment. Further, the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.[70]

Additionally, some case law tends to reduce the concern over administrative powers so long as they are held in a fiduciary capacity.[71]

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68. The First Circuit in Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970) apparently overruled its decision in the principal First Circuit case. The court held "that no aggregation of purely administrative powers can meet the government's amorphous test of 'sufficient dominion and control' so as to be equated with ownership." *Id.* at 603.

69. *See* Treas. Reg. §§ 25.2511-1(g), 25.2514-1.

70. Similar language for gift tax purposes is found in Treas. Reg. § 25.2514-1(b).

71. *See* Estate of Rolin v. Comm'r, 68 T.C. 919 (1971), *aff'd* 588 F.2d 268 (2d Cir.

Prudence, however, requires the draftsman to examine local law and review the proposed administrative provisions of nonmarital trusts so that the fiduciary obligation of the trustee-spouse is not lessened so as to produce an unfavorable tax effect. The following are commonly used administrative provisions which should be reviewed.

A. *Principal and Income*

Some trusts contain boilerplate provisions similar to the following:

> The trustee shall have the power, in her absolute discretion, to determine how all receipts and disbursements shall be credited, charged, or apportioned as between principal and income.

The effect of a provision which purports to give the trustee such absolute discretion is unclear.[72] The clause may lift the restrictions (or some of them) placed upon trustees by local law. If so, the trustee might charge a disbursement against principal which would otherwise be chargeable against income or credit a receipt to income which would otherwise be credited to principal. If the effect of such boilerplate should be to allow the trustee income beneficiary to act in a non-fiduciary capacity, the trust principal would be included in the trustee's estate under section 2041. Such clauses simply should not be included in the trust instrument.[73]

Additionally, it may even be unwise to rely on a jurisdiction's Principal and Income Act. For example, the Uniform Principal and Income Act (1931 version) does not authorize a depreciation reserve with respect to property held by the trustee.[74] In jurisdictions which have adopted the 1931 Act, such a reserve should be required in the trust instrument.

Also, under both the 1931 Act and the 1962 Revised Act, the detriment of all bond premiums and the benefit of all bond discounts inures to principal. The 1962 Revised Act does, however, provide an exception to this general rule:

> The increment in value of a bond or other obligation for the pay-

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1978); Robinson v. Comm'r, 75 T.C. 347 (1980), *aff'd* 675 F.2d 774 (5th Cir. 1982), *cert. denied*, 103 S. Ct. 300 (1982).

72. *See supra* text accompanying notes 16-20.

73. From a drafting standpoint, it may be well to expressly require the trustee to act in accordance with a standard of good faith in allocating principal and income. See Form F of the Appendix for an example of such a provision.

74. Section 13(a)(2) of the Revised Uniform Principal and Income Act (1962) does require a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles.

ment of money payable at a future time in accordance with a fixed schedule of appreciation in excess of the price at which it was issued is distributable as income.[75]

This exception would not apply to Treasury Bills as they do not have a "fixed schedule of appreciation." Furthermore, neither act authorizes the amortization against income of a bond purchased at a premium. Again, the solution would be to provide in the trust instrument that the increment in value of Treasury Bills purchased at a discount be distributable as income and to further require that bond premiums be amortized against income.

The trust instrument may need to accommodate other provisions of local principal and income acts. Particular attention should be given to depletion provisions and provisions relating to unproductive and under productive property.

B. *Power to Terminate the Trust*

To avoid the administrative costs of administering a trust which for one reason or another has decreased in value, some trust instruments authorize the trustee to terminate the trust and distribute the trust principal to the income beneficiaries. If, as in the prototype, the surviving spouse is both the income beneficiary and the trustee of the nonmarital trust, the trust principal may be included in her gross estate under section 2041. The Service has successfully asserted that position before the courts.[76]

Despite the existence of case law favorable to taxpayers on this issue,[77] prudence suggests that no such termination power be included in the trust instrument. If such a power is deemed important, it should be given to someone other than the spouse-income beneficiary, or any other beneficiary for that matter. Another alternative would be to grant the power to the trustee solely if the market value of the trust principal is less than a stated dollar amount. Such a dollar amount might be expressly adjusted for inflation with some well-known price index.

C. *Miscellaneous Powers*

A number of other powers commonly included in trust instru-

75. Revised Uniform Principal and Income Act § 7(b) (1962).

76. *See* Maytag v. United States, 493 F.2d 995 (10th Cir. 1974).

77. *See* Estate of McCoy v. United States, 374 F. Supp. 1321 (W.D. Tenn. 1974), *aff'd* 511 F.2d 1090 (6th Cir. 1975); Estate of McCord v. United States, 75-1 U.S. Tax Cas. ¶ 13,042 (E.D. Mich. 1974), *aff'd* 516 F.2d 832 (6th Cir. 1975), *cert. denied*, 423 U.S. 995 (1975).

ments should be considered. One is a power to limit the liability of the trustee. The danger of such exoneration provisions when used in conjunction with a dispositive power to distribute principal to the spouse according to an ascertainable standard has already been noted.[78] The Service has also challenged exculpatory clauses when used in conjunction with other broad administrative powers.[79]

Other powers which should be avoided include: (1) a power to lend trust property to beneficiaries without adequate consideration or adequate security; (2) a power to exchange trust property with property owned by the trustee; and (3) a power which attempts to eliminate the trustee's obligation of making accountings to the remaindermen. These powers could have an estate tax consequence.

V. Life Insurance on the Life of the Spouse-Trustee

Prior to the enactment of the Economic Recovery Tax Act of 1981,[80] a frequently used estate planning device was "cross ownership" of life insurance policies. The wife would own policies on her husband's life and the husband would own policies on his wife's life. The primary purpose was to keep the insurance proceeds out of the insured's gross estate because of the limitation on the amount of the marital deduction. The new unlimited marital deduction has eliminated the estate tax advantages of cross ownership. The insured's estate can now deduct the full amount of the life insurance proceeds paid to his spouse as beneficiary without incurring any federal estate tax liability on his death.

While the estate tax advantage has been eliminated, it is likely that some spouses will continue cross ownership on existing policies even though they probably will not acquire additional policies in cross ownership. In the absence of a specific devise to the contrary, such policies will likely become assets of the nonmarital trust. If the surviving spouse is the trustee of that trust, the Service will likely argue that the proceeds of the insurance should be included in the insured-trustee's gross estate if she dies while acting as trustee. The Service has prevailed in several cases before the Fifth Circuit.[81] The Service has also prevailed before the Court of

78. *See supra* text accompanying notes 16-20.

79. *See* Greer v. United States, 448 F.2d 937 (4th Cir. 1971).

80. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

81. Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); Rose v. United States, 511 F.2d 259 (5th Cir. 1975). However, there is at least one recent indication that the Service may be revising its stance on this issue. *See* Estate of Bloch v. Comm'r, 78 T.C. 850, 857 (1982).

Claims.[82] Contrary case law exists in other circuits.[83]

From a planning standpoint, consideration should first be given to changing ownership of such policies. With the unlimited marital deduction, the insured could be designated as the owner of the policies and the spouse designated as a beneficiary. Such a beneficiary designation should qualify for the marital deduction. If the primary objective is to remove the insurance proceeds from the gross estates of both husband and wife, consideration should be given to transferring ownership of the policies directly to the children, or a trust for their benefit.

If for some reason cross ownership is still desired, the wills of both spouses could direct that all policies of life insurance on the life of the other spouse be distributed to the children. If a trust is thought advisable for the policies, a trustee other than the insured spouse should be directed for those assets.

VI. Savings Clauses and Other Defensive Drafting Suggestions

Because of the uncertainties associated with both dispositive and administrative powers in a nonmarital trust where the surviving spouse is named trustee, prudence would suggest that the draftsman include a savings clause indicating the testator's primary intent that none of the trust principal be included in her estate.[84]

The effectiveness of any savings clause is, itself, uncertain. Whether the clause will prevent the trust principal from being included in the surviving spouse's gross estate probably depends upon the defect sought to be cured. It is unlikely, for example, that such a clause would undo a dispositive provision in the trust instrument which allows the surviving spouse to invade principal for her happiness. Such would clearly constitute a general power of appointment outside the ascertainable standard exception of section 2041(b)(1)(A). However, such a clause would probably cure an ambiguity between some administrative provision and the testator's intent not to have the trust principal included in the trustee-spouse's gross estate. A number of courts have upheld the effec-

82. Genser v. United States, 600 F.2d 1349 (Ct. Cl. 1979).

83. Hunter v. United States, 624 F.2d 833 (8th Cir. 1980), *aff'g* 474 F. Supp. 763 (W.D. Mo. 1979); Connelly v. United States, 551 F.2d 545 (3d Cir. 1977) *aff'g* 398 F. Supp. 815 (D.N.J. 1975); Skifter v. Comm'r, 468 F.2d 699 (2d Cir. 1972), *aff'g* 56 T.C. 1190 (1971).

84. Such a clause could be modeled after that suggested by Johanson, *The Use of Tax Savings Clauses in Drafting Wills and Trusts*, 15 Inst. on Estate Plan. ¶ 2111 (1981). See Form G of the Appendix for an example of such a clause.

tiveness of savings clauses.[85] Not all such decisions, however, have been favorable to the taxpayer.[86] If properly drafted, the clause should avoid the effect of such adverse decisions.

In addition to a savings clause, the trust instrument might also expressly authorize the trustee to surrender powers. Such may be advantageous in the income tax area. A power believed not to cause trust income to be taxed to the trustee could in fact cause such taxation, either through error on the part of the draftsman or through subsequent changes in the law.[87] If the continued existence of a power is thought to be critical, the surrender power might be coupled with authority to appoint a co-trustee, who could, in turn, exercise the surrendered power.[88]

VII. Conclusion

The appointment of the surviving spouse as trustee of the nonmarital trust has disadvantages. The extent of these disadvantages increases with the additional dispositive powers given to the spouse-trustee. Clearly, for example, an intervivos power to distribute principal to the testator's children and their descendants gives rise to generation skipping transfer tax exposure. The five or five power gives rise to estate tax exposure in the year of the surviving spouse's death as well as income tax exposure during the surviving spouse's lifetime.

In addition to these disadvantages, the addition of dispositive powers gives rise to uncertainties. For example, while some courts have held that a power of withdrawal limited by an ascertainable standard will not give rise to income taxation under section 678, the matter is far from conclusively resolved. While the regulations suggest that there will be no gift tax consequence if the income beneficiary has authority to distribute principal to other beneficiaries limited by an ascertainable standard, there is little case law upon which to rely.

In addition to these disadvantages and uncertainties, it is im-

85. *See* Guiney v. United States, 425 F.2d 145 (4th Cir. 1970); Northeastern Pennsylvania Nat'l Bank & Trust v. United States, 360 F. Supp. 116 (N.D. Pa. 1973); and Rev. Rul. 75-440, 1975-2 C.B. 372.

86. *See* Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944); Rev. Rul. 65-144, 1965-1 C.B. 442.

87. See Form H of the Appendix for an example of a clause which authorizes a trustee to surrender powers. That form is modeled after one found in Bromberg & Fortson, *Selection of a Trustee: Tax and Other Considerations*, 19 Sw. L.J. 523, 560 (1965).

88. See Form I of the Appendix for an example of a clause which authorizes the appointment of a co-trustee and the surrender of powers to that trustee. That form is modeled after one found in Bromberg & Fortson, *id.* at 563.

portant to note that even if the trust includes all four of the proposed additional dispositive powers discussed in this article, the trust could be even more flexible if the spouse were not the trustee. If she were not, the trustee could make discretionary distributions of principal for her "general best interests" her "welfare," her "happiness," or some other very broad guideline.

One of the most significant disadvantages of naming the spouse as trustee is in the area of income distributions. Neither the prototype, nor any of the additional dispositive provisions mentioned in this article, suggest that the spouse could accumulate income or sprinkle income to a class of beneficiaries which might include the spouse and the testator's descendants. Section 678(a)(1) would certainly cause the surviving spouse to be taxed on the trust income because she would have a power exercisable solely by herself to vest the income in herself.

If, for example, a corporate trustee were appointed, the trust could include such accumulation and sprinkling provisions. There would be a significant practical advantage. Income could be distributed to those beneficiaries who have the greatest need. Additionally, accumulation and sprinkling provisions would add significant opportunities for income tax planning. For example, the trustee by distributing appreciated property could avoid capital gains taxation on that appreciation. The beneficiary would receive a stepped-up basis in the property.[89] If, however, the trust instrument requires the distribution of current income, the distribution of appreciated property will be treated as satisfying a legal obligation of the trust, and the trust would have to recognize the gain.

The major tax advantages of accumulation trusts arise from the taxation of such accumulated income to the trust as a separate taxpayer. Income could be accumulated in the trust when the beneficiary is in a higher income tax bracket. The accumulated income could be distributed subsequently to the beneficiary when the beneficiary's tax bracket is lower. Of course, the throw back rules of sections 665 and 667 would apply. Under these throwback rules, the beneficiary is taxed on the accumulated income in a manner similar to that as if the beneficiary had received the trust income in the year it was earned by the trust. Consequently, with the throwback rules, it is possible that we will not achieve an overall tax savings. But equally clearly, we may achieve tax deferral without interest. Furthermore, it is possible to achieve an overall tax

89. *See* Treas. Reg. § 1.661(a)-2(f); Rev. Rul. 72-295, 1972-1 C.B. 197; Rev. Rul. 67-74, 1967-1, C.B. 194; Rev. Rul. 64-314, 1964-2 C.B. 167.

savings when distributions are planned with the throwback rules in mind. For example, if the trust beneficiary has substantial taxable income while the trust is accumulating its income and if distributions to that beneficiary can be delayed five years until after the beneficiary's taxable income has been reduced (perhaps five years after the beneficiary retires), the throwback rules can result in an overall tax savings as well as tax deferral. Or, distributions of accumulated income could be made to a beneficiary (a child or grandchild of the testator) who was under the age of twenty-one when the trust accumulated the income.

Additional tax savings can be achieved in such a trust where the permissible income beneficiaries include the testator's children and other descendants. The trustee could distribute income to those beneficiaries in the lowest tax brackets to achieve the greatest overall tax savings. As noted, however, no distribution should be made which would satisfy a legal obligation of support.[90]

In short, a number of non-tax and tax benefits have been lost when the surviving spouse is named the trustee of the nonmarital trust. To estate owners with large estates—probably in excess of $1,500,000 or $2,000,000—this is reason enough not to name the surviving spouse as trustee. To estate owners with smaller estates, the loss of income tax planning opportunities can perhaps be compensated for with the use of other income tax planning devices she can use with her own property. She may make gifts of income producing assets to her children, establish Clifford trusts, and make investments in municipal bonds and other tax shelters. For the client whose sole motive in establishing a nonmarital trust is the minimization of the federal estate tax, the appointment of the surviving spouse as trustee of a properly drafted trust is an estate planning option worthy of consideration.

90. *See supra* text accompanying notes 35-38.

APPENDIX

FORM A

At any time and from time to time during the continuance of the trust, the trustee shall pay to or expend for the benefit of my wife, so much or all, if any, of the principal the trustee determines to be necessary considering other resources known to the trustee to be available to my wife, to provide for her health, education, and support in the manner of living to which she has been accustomed.

FORM B

Subject to the limitation of the sentence immediately following, at any time and from time to time during the continuance of the trust, the trustee shall pay to or expend for the benefit of my children and their descendants, so much or all, if any, of the principal the trustee determines to be necessary, considering other resources known to the trustee to be available to my children and their descendants, to provide for their health, education, and support. However, no distribution shall be paid, distributed or applied for the support which the trustee is legally obligated to provide a beneficiary, nor to defray any legal obligation of the trustee.

FORM C

The trustee shall also distribute to my wife such portion of the principal of the trust, not exceeding in any calendar year the greater of $5,000 or five percent of the value of the principal of the trust at the end of the calender year, as she from time to time requests in writing. The power of my wife to withdraw principal shall be noncumulative. Any amount not withdrawn in any calendar year shall lapse and may not be withdrawn in any later year.

FORM D

Upon the death of my wife after my death, the trustee shall distribute the trust principal to, or in trust for the benefit of, such person or persons among my descendants, upon such conditions and estates, with such powers, in such manner and at such time or times as my wife appoints and directs by will specifically referring to this power of appointment.

To the extent my wife does not effectively exercise her power of appointment, upon her death (or upon my death if my wife does not survive me), the trustee shall divide the trust principal in equal separate shares, one for each then living child of mine and one for the then living descendants, collectively, for each deceased child of mine. The trustee shall distribute each share for a living child of mine to such child. The trustee shall distribute each share set aside for the descendants of a deceased child of mine to such descendants, by representation.

FORM E

If my wife survives me, I devise all of my residuary estate, other than any property which my wife has effectively disclaimed, to my wife. I devise all of my property which my wife has effectively disclaimed, in trust to the trustee hereinafter named under the following terms and conditions:

FORM F

The discretion of the trustee in administering the trust, including the discretion of the trustee in determining allocations between principal and income, is not absolute. Rather such discretion is subject to the standard of reasonableness and good faith to all beneficiaries. The trustee shall act fairly and impartially between the income and the remainder beneficiaries.

FORM G

It is my primary intent that the property comprising the trust estate of this trust shall not be included in my spouse's gross estate for federal estate taxation purposes, notwithstanding any provision in my will that might be construed as comprising this objective. All questions regarding this trust shall be resolved accordingly. The powers and discretions of the personal representative and the trustee with respect to administration of my estate and of the trust estate shall not be exercised or exercisable except in a manner consistent with my intent as expressed in this paragraph. To the extent that any other provision of my will conflicts with my primary intent as expressed in this paragraph, giving rise to an ambiguity, the ambiguity shall be resolved as directed in this paragraph.

FORM H

The trustee shall have power and authority to surrender, release, renounce, or disclaim any one or more of the powers given to the trustee. Any such surrender, release, renunciation, or disclaimer shall be made by written instrument and shall be acknowledged. After any power has been so surrendered, released, re-

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nounced, or disclaimed, it shall never again be exercised by that trustee.

FORM I

The trustee may at any time designate another individual or a corporation to act as co-trustee. Such designation shall be by written instrument, acknowledged, and delivered to the designated co-trustee. Any designation shall be revocable until the co-trustee has accepted appointment and entered upon its duties as co-trustee; such revocation shall be in the same form as the original designation. Such designation may delegate, in whole or in part, any or all of the powers and discretions given to the trustee.